



## CRS Report for Congress

# The U.S. Financial Crisis: Lessons From Sweden

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### Summary

In the early 1990s, Sweden faced a banking and exchange rate crisis that led it to rescue banks that had experienced large losses on their balance sheets and that threatened a collapse of the banking system. Some analysts and others argue that Sweden's experience could provide useful lessons for the execution and implementation of the Emergency Economic Stabilization Act of 2008<sup>1</sup>. The banking crisis facing the United States is unique, so there are no exact parallels from which to draw templates. Sweden's experience, however, represents a case study in how a systemic banking crisis was resolved in a developed country with democratic institutions. The Swedish central bank separated out good assets, which it left to the banks to oversee from bad assets, which it placed in a separate agency with broad authority to work out debt problems or to liquidate assets. Four lessons that emerged from Sweden's experience are: 1) the process must be transparent; 2) the resolution agency must be politically and financially independent; 3) market discipline must be maintained; and 4) there must be a plan to jump-start credit flows in the financial system. This report provides an overview of the Swedish banking crisis and an explanation of the measures Sweden used to restore its banking system to health. This report will not be updated.

### Background

Sweden's banking crisis grew slowly over time and was the result of a number of policy decisions<sup>2</sup>. In particular, the crisis arose from a set of economic policies that attempted to: 1) support Sweden's fixed exchange rate policy, 2) deregulate the financial sector, 3) expand credit, and 4) provide low-cost loans for residential purchases and for

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<sup>1</sup> Dougherty, Carter, Stopping a Financial Crisis, The Swedish Way, *The New York Times*, September 23, 2008; Purvis, Andrew, Sweden's Model Approach to Financial Disaster, *Time*, September 24, 2008.

<sup>2</sup> Englund, Peter, The Swedish Banking Crisis: Roots and Consequences, *Oxford Review of Economic Policy*, Autumn 1999. P. 80-97.

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university students. Eventually, a drop in asset values weakened the balance sheets of banks and reduced liquidity in the economy. One key factor in Sweden's financial crisis was a set of policy measures the country adopted in the mid-1980s to liberalize the highly regulated financial sector. Prior to this liberalization, banks, insurance companies, and other institutions were subjected to lending ceilings and were required to invest in bonds issued by the government and mortgage institutions.

Large central government deficits and a national policy that favored residential investment led to requirements that banks hold more than 50% of their assets in such bonds, typically with long maturities and low interest rates. In addition, the banks were carefully scrutinized and monitored by Riksbank, Sweden's central bank. This close supervision meant, however, that the banks themselves were unaccustomed to performing risk analysis, and were ill-prepared to perform risk analysis on commercial paper associated with real estate loans. This lack of experience led to unhealthy risk taking when the nation began to deregulate its financial sector and allow banks to participate in a broader array of financial instruments. Indeed, some analysts argue that it was this inexperience, rather than the deregulation effort itself, that played a role in the banking crisis. Sweden also favored housing and college education by operating a system that provided loans with highly favorable terms with little or no credit evaluation. Other economic problems compounded Sweden's efforts to gain control over the macroeconomic conditions within the country and place the economy on a well-balanced positive growth track<sup>3</sup>.

## Deregulation

In the early to mid-1980s, Sweden began deregulating its financial markets at such a rapid pace that it took most observers by surprise<sup>4</sup>. In part the deregulation was spurred by the rapid development that had occurred in the growth of money market accounts, certificates of deposit, and government securities that arose from growing central government budget deficits. These actions shifted Sweden's monetary policy to an expansive posture and allowed banks, mortgage institutions, finance companies, and others to compete in the domestic credit market. The expansion in credit helped stimulate economic growth, but it also fed inflation and added to general expectations of inflation in the economy. In addition, Sweden's tax system stimulated consumer borrowing by allowing taxpayers to fully deduct interest payments and exchange controls stimulated corporate borrowing by favoring domestic investment over foreign investment.

These activities combined with an expansionary fiscal policy to increase credit in the economy added to the stock, or the overall amount, of debt. This credit boom pushed up the prices of corporate stocks and real estate — both commercial real estate and residential housing. As the pace of economic growth accelerated, the rate of price inflation also increased, which led to the Swedish Krona being overvalued. By the late 1980s, Sweden removed a broad range of foreign exchange controls, but it maintained its fixed exchange rate system. During this time, Sweden experienced current account deficits and large outflows of direct investment and other long-term capital, which led to

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<sup>3</sup> Ibid, p. 83-84.

<sup>4</sup> Ingves, Stefan, *The Nordic Banking Crisis From an International Perspective*, International Monetary Fund, September 11, 2002.

a growing stock of private sector short-term debt in foreign currency<sup>5</sup>. In essence, Swedish households and businesses were borrowing in foreign currency at interest rates that were below those that were charged for loans denominated in Swedish Krona. The result of this borrowing was a substantial amount of exchange rate risk in the balance sheets of the private sector.

By the early 1990s, a combination of reforms in the tax system and periods of high interest rates caused asset prices to fall. As the pace of economic growth cooled, the rate of unemployment began to rise, public sector debt rose, bankruptcies surged, and the banking system was shocked as the rising bankruptcies forced banks to curtail their lending activities in order to build up their loan loss reserves. A further setback for the economy occurred with German reunification in 1990, which resulted in higher German interest rates and an appreciating currency. Sweden's fixed exchange rate policy obligated Sweden to import the higher German interest rates, pushing its own interest rates higher and busting a property market bubble. When Sweden was forced to abandon its exchange rate peg in November 1992, the real exchange rate fell substantially, while real interest rates remained high, which caused a large number of private sector loans to become non-performing.

## The Financial Crisis

In early 1990, Sweden's economy appeared to be doing well. The unemployment rate was at an all-time low and the stock market was booming. At the same time, the rate of price inflation was rising, the real effective exchange rate was appreciating, and there was a general consensus that the economy was growing at an unsustainable rate. In addition, rising stock market prices reinforced the continued expansion in real estate, especially in the commercial property market. By mid-1990, however, commercial occupancy rates had fallen, pushing down the price of stocks for both the real estate and construction sectors<sup>6</sup>.

The first financial firm to feel the effects of the drop in real estate prices was Nyckeln, one of Sweden's fastest growing financial firms. Nyckeln, like other financial firms, was owned by several of Sweden's largest banks. Nyckeln had achieved its rapid growth by specializing in commercial real estate financing and financing its operations through a new type of commercial paper called *marknadsbevis*, which the banks had guaranteed. At this time, Sweden's commercial paper market had become the third largest commercial paper market in Europe. In 1991, the value of commercial paper dropped sharply when interest rates in Sweden began rising as a result of rising international rates that were pushed up by German reunification. With the fall of Nyckeln, two of Sweden's six largest banks were heavily affected and announced that they could not meet their regulatory capital requirements.

Concern quickly spread through all of Sweden's commercial paper market, which essentially shut down. By the end of the year, three of Sweden's major financial firms

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<sup>5</sup> Backstrom, Urban, *What Lessons Can be Learned From Recent Financial Crises? The Swedish Experience*. Federal Reserve Symposium "Maintaining Financial Stability in a global Economy," August 29, 1997.

<sup>6</sup> Englund, *The Swedish Banking Crisis*, p. 84-89.

had defaulted. Two of the major banks faced actual insolvency problems and the government of Sweden, the major shareholder in the two banks, injected equity into one of the banks and issued guarantees to the other bank for loans that enabled the banks to fulfill their capital requirements. By the spring of 1992, yet another Swedish bank went bankrupt. At this point, the Swedish government took ownership of the third bank and began to treat the defaults and bankruptcy as a crisis. The government refused to offer complete forbearance of the non-performing loans and did not offer unlimited liquidity support, but opted to guarantee the bank's debts, an action it would extend to all of Sweden's banks within a few weeks.

As a major step in resolving the banking crisis, the central bank divided each bank into two separate entities, one with its good assets, the other with its bad assets. The entities holding the good assets continued to operate under their old names and were later merged under a new name. The bad assets were transferred to two asset management companies. The asset management companies were owned by the government, but had a high degree of independence and were free of many of the regulations that applied to banks. The management companies attempted to assess the value of the non-performing loans they had inherited and then moved to rescue whatever economic value they could. As a result, the companies injected equity into troubled borrowers to maintain and restore their values and, at times, took over defaulting companies, which they ran as a private owner until the companies could be liquidated. Assets were sold in three ways: initial public offerings on the Stockholm stock exchange; corporate transaction outside the stock exchange; and transactions involving individual properties. A quick rebound in the Swedish economy that stemmed from an increase in economic growth in Europe and elsewhere allowed all of the managed assets to be liquidated by 1997, ultimately at a lower cost to the Swedish taxpayers than had initially been projected.

## **Lessons Learned From Sweden's Experience**

Each financial crisis is unique and largely dependent on the specific combination of national and international factors that exist at the time. In addition, the resolution of the crisis is intricately interwoven with a broad set of laws and national characteristics that are unique to each crisis and each national setting. A number of differences between the Swedish and U.S. experiences are readily apparent.

- Unlike the situation in the United States, the Swedish government had a financial stake in the largest banks prior to the crisis. This made the Swedish government a direct stakeholder in the institutions and provided an impetus for it to act.
- Sweden's real estate loans and commercial paper were nearly all domestically held, so that it did not face both a domestic and international financial issue.
- Many nonperforming loans in Sweden were a result of unhedged private sector exchange rate risk when the currency peg collapsed.
- In the United States, the financial sector problems are linked to the securitization of mortgages, which led to credit exposures that extended well beyond the retail banking sector.

- Sweden's economy is small and open, which enables it to rely on an export-led recovery strategy. The U.S. economy is larger relative to the global economy and it has a strong influence on the pace of global economic growth. As a result, the United States is more likely to rely on a recovery strategy that is based on domestic demand.

An analysis of the Swedish banking crisis of the 1990s reveals that there are a number of factors that were inherently responsible for the resolution of the crisis that apply specifically to the Swedish case. Despite these caveats, the Swedish experience may offer some insight into one possible way of resolving a domestic financial crisis. One factor that helped Sweden quickly resolve its financial crisis was a strong international economic recovery that pushed up real estate values in Sweden and improved the balance sheets of banks. Others argue that a number of procedural factors, in addition to the economic recovery, helped bring the financial crisis to a resolution. In particular, they argue that four factors played an important role in this process in Sweden and could prove beneficial in resolving other financial crises:<sup>7</sup>

- First, transparency of the process is important. In Sweden, expected losses were recognized early on and helped to preserve the confidence of the market.
- Second, the process seems to work best with a politically and financially independent agency. This type of structure shields decision makers from political pressures, especially as banks are closed and assets are liquidated. Financial independence of the agency gives credibility to the notion of political independence. In addition, financial independence allows for a rapid response when funding needs emerge suddenly and waiting for a government appropriation is impractical.
- Third, is the importance of maintenance of market discipline and avoiding blanket guarantees. According to this concept, extending blanket guarantees increases the risk of future financial crisis because it weakens market discipline exerted by uninsured creditors. Blanket guarantees of all the liabilities of problem institutions in the throes of a crisis reduces the credibility of claims that such guarantees will not be extended in future bank failures. Although the guarantees were intended to calm the markets, some analysts argue they likely reduced incentives to monitor bank risk by creditors. Some analysts argue that a better solution would be a bank holiday that would allow bank examiners enough time to assess the extent of non-performing loans while it would allow insured depositors access to their funds. In addition, uninsured depositors would be allowed to move their funds out, but would be forced to assume some of the losses. Also non-viable banks would not be eligible to receive financial support from the government and public funds would not be used to support a non-viable institution.

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<sup>7</sup> Ergunor, O. Emre, *On the Resolution of Financial Crises: The Swedish Experience*, Federal Reserve Bank of Cleveland Policy Discussion Paper, June 2007, p. 1-12.

- Fourth, is a plan to jump-start credit flows in the financial system by repairing the damaged creditworthiness of the broader economy. Even if banks can be completely restored to financial health through recapitalization, borrowers may be in no position to repay any new loans they may get. Such a plan may include such items as a fiscal stimulus to aid borrowers.